



TOP NEWS FROM THE POLISH MARKET

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 - Retail sales lower than expected
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MACROECONOMICS

Lower industrial output, PPI in line with expectations

The industrial output was up by 12.4% y/y in April compared to 11.3% y/y recorded in March. The annual dynamics corrected for the effect related to the number of working days dropped, however, to 10.9% from 13.3% in March. Note that this estimate may be biased downward because of the peculiarity related to the accounting for the beginning of the long weekend starting in April. In our opinion a drop in April's industrial output does not necessarily mean that the trend had reversed – we do not see any indication that the domestic and external demand for Polish goods has deteriorated substantially. Hence, we expect the GDP dynamics in the second quarter of 2007 to ease only slightly relative to the 7.5% y/y estimated for the first quarter of 2007. The Polish economy is still experiencing a boom in construction. We also expect private consumption to expand at a record rate which will clearly lead to a change in the structure of economic growth in Poland.

The PPI index rose by 0.6% m/m in April which translated into an annual inflation rate of 2.3%. As a comparison, in March the PPI inflation amounted to 3.3%. A drop in April's PPI was however fully anticipated, as it owed to a high base effect - in 2006 there was a price hike for energy. According to our estimates the PPI inflation rate has also been affected by the zloty's appreciation which partly neutralized higher oil prices. The firming zloty and stabilization of crude oil prices may eventually lead to a further decline in PPI inflation in the summer. The PPI inflation will breach the 3% level at the end of the year again.

Retail sales lower than expected

The retail sales dynamics eased to 15.1% y/y in April from 19.2% recorded in March. In real terms the retail sales grew by 13.6% compared to 17.7% in March. Such a drop is surprising given the latest business surveys for the retail trade – both April's and May's indicators stayed at their boom level.

In our opinion a decline in the annual dynamics of the retail sales may be only temporary. First, the detailed breakdown indicates that a decline is mainly due to lower food sales and sales in "remaining categories", which proved to be highly volatile. The sales of cars and household appliances remained very strong. Second, we do not see any structural indication that the consumption boom is over. Rising employment (employment rose by 5.3% y/y in the first quarter of 2007), wages and credits for consumption will boost consumer spending in the coming months. Thus, the retail sales dynamic should top 16-18% again in May.

Core inflation dropped to 1.5% in April

3 out of 5 net inflation measures dropped in April (including core inflation net of food and fuels from 1.7% to 1.5%). The main reason behind the drop was the base effect – a gas price hike took place in April 06. This is reflected in the inflation net of administered prices rising to 2.6%, above the NBP target. In our opinion, the core inflation could rise to 1.6% in June. In July another base effect should knock it down to ca. 1.2%. In the second half of the year we expect the core rates to start picking up more significantly, to ca. 1.7-1.8% in December.

D. Filar: rate hike may come in June-August period

D. Filar of the MPC reckons inflation should stay close to the inflation target this year, but a pick up at the end of the year may lead to a rise in inflationary expectations. As a result, a rate hike may be needed soon. He pointed to a recent deterioration in wages – productivity relation, and also showed that the real interest rates are the lowest in Europe. He thinks the key data will come in the June-August period and another hike in this period may be needed.

A. Sławiński: growth still above potential

A. Sławiński pointed to growth rate visibly above potential, which may lead to more serious inflationary risks. He admitted that he is aware of serious inflationary risks, which makes the monetary policy running tougher this year.

MPC minutes: strong disagreement among MPC members as to the influence of several factors on future inflation

We stick to our view: 25 bps rate hike to come in July

Outlook for the 2008 budget deteriorates

Minutes from the April MPC meeting (25 bps hike) indicate strong differences among the MPC members. Although the majority of MPC members acknowledged inflation risks – labour market or growth rate above potential – they differed in the evaluation of the strength of these factors. E.g. regarding the pick up in wages dynamics – some of the MPC members were not certain whether the rapid growth in March was a result of trend pick up, or one-off factors. Also regarding the inflationary projection, the MPC was not able to present one opinion – part of the MPC members considered the projection to be too high, part – too low, and finally some MPC members thought it was accurate. With such a disagreement within the MPC, it should not be considered a surprise that the MPC wasn't unanimous in the decision to raise rates.

Our comment:

The recent comments and the April minutes confirm that the MPC is divided on whether further hikes are needed. With a casting vote of the NBP President S. Skrzypek, this excludes a hike in May. We however maintain our view that the MPC will hike rates by 25 bps in July – based on a higher June CPI reading (our forecast 2.6%), strong economic growth coupled with high pace of wages growth and a new inflationary projection (in our opinion higher than the one presented in April).

The Polish government has finally restored the annual indexation of pensions effective in 2008. In line with earlier announcements the pensions will be indexed to the previous inflation rate and at least to 20% of the real wage growth rate. The additional costs for the budget are estimated at 5.7 bn PLN. Indexation besides the planned tax rate cuts, resulting in 18 bn PLN lower budget revenues, and the pro-family programme will substantially deteriorate the 2008 budget balance. Thus, it will be very hard to achieve such an extraordinary figure as in 2006 and probably in 2007.

FIXED INCOME

Correction has ended, rates higher again

RECOMMENDATION:

Quite along with our expectations, the strengthening on the market turned to be only temporary correction, supported by slightly lower industrial output and PPI data, but after that rates started drifting north again. And not only IRS market is well bid - also some supply of bonds finally appeared, since papers became ridiculously expensive to the swap curve. This week starts off very quiet due to holiday in both London and US. We do not expect much action on the market till MPC decision on Wednesday. Since some players seem not to agree with current direction on the market, then not-very-hawkish statement may spark some receiving action; for us that would be just another occasion to add to the pay position.

Pay dips. Prefer 2y-5y sector.

MONEY MARKET

Cheap end of the reserve ahead

Mixed figures do not clarify situation

A stable week as far as liquidity is concerned. A reasonable open market operation this time (21.7 billion PLN vs 20.8 billion PLN) should provide an easy and rather cheap end of the reserve requirements settlement period.

Mixed figures still do not clarify whether the last rates hike was pre-emptive or just started the cycle. Lower industrial output and retail sales according to expectations supported the debt, but let us not forget that those figures are still very high. That is why we sustain our view that the next 25 bps hike will take place in July. Poor sentiment for the emerging markets plus nervous

enough

days in Ukraine only slightly affected the Polish market.

RECOMMENDATION:

Sell longs on hikes.

FOREIGN EXCHANGE**Zloty stable**

Last week the Zloty traded range-bound. The market still expects a correction to 3.8500. This is not likely to happen in the following week, however, as the coming week lacks significant market-mover data release. EUR/USD also traded stable around 1.3450. USD/PLN traded at around 2.8200.

Volatility stable

Implied volatilities remained at their previous week's levels. The 1M EUR/PLN traded at 6.8, the rest of the curve (till 1Y) at 6.4-6.5. USD/PLN traded at about 7.6-7.7 along the curve.

RECOMMENDATION:**Zloty stable**

Spot:
Main supports / resistances:
EUR/USD: 1.3400 / 1.3550
EUR/PLN: 3.7800 / 3.8200
USD/PLN: 2.8000 / 2.8400

In the following week we still may see EUR/PLN trade stable, that is why we do not recommend any directional positions.

Short Gamma

Options:

With realized volatility well below the implied ones, and the EUR/PLN range-bound we still recommend selling Gamma and earning the decay.

MARKET PRICES UPDATE**MONEY MARKET RATES**

Money market rates (Closing mid-market levels)						
date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
21-05-07	4.41%	4.44%	4.55%	4.58%	4.75%	4.78%
22-05-07	4.41%	4.44%	4.54%	4.58%	4.76%	4.78%
23-05-07	4.40%	4.44%	4.53%	4.59%	4.76%	4.78%
24-05-07	4.40%	4.44%	4.53%	4.59%	4.76%	4.78%
25-05-07	4.41%	4.45%	4.54%	4.61%	4.78%	4.79%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
	21-05-07	4.47%	4.62%	4.81%	4.94%
22-05-07	4.48%	4.62%	4.82%	4.96%	4.92%
23-05-07	4.48%	4.63%	4.83%	4.99%	4.92%
24-05-07	4.49%	4.65%	4.85%	5.02%	4.95%
25-05-07	4.49%	4.64%	4.83%	5.02%	4.94%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)								
date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK1208	IRS	PS0511	IRS	DS1017
21-05-07	4.78%	4.43%	5.00%	4.55%	5.19%	5.08%	5.25%	5.25%
22-05-07	4.78%	4.43%	5.01%	4.55%	5.20%	5.09%	5.25%	5.24%
23-05-07	4.78%	4.42%	5.03%	4.54%	5.23%	5.11%	5.25%	5.25%
24-05-07	4.78%	4.40%	5.08%	4.56%	5.29%	5.15%	5.34%	5.31%
25-05-07	4.79%	4.40%	5.08%	4.68%	5.28%	5.17%	5.32%	5.32%

PRIMARY MARKET RATES

Last Primary Market Rates							
	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	07-05-07	08-05-07	95.665	4.48%	900	1342	900
OK0709	07-04-04	09-07-25	89.970	4.69%	1000	2463	1000
PS0412	07-05-16	12-04-25	98.360	5.13%	1500	8541	1500
DS1017	07-04-11	17-10-25	99.976	5.24%	1800	3473	1800

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
21-05-07	7.90	7.80	7.80	7.90	1.20	1.30	0.35	0.60
22-05-07	7.90	7.80	7.80	7.90	1.20	1.30	0.35	0.60
23-05-07	7.90	7.80	7.80	7.90	1.20	1.30	0.35	0.60
24-05-07	7.80	7.80	7.80	7.90	1.20	1.30	0.35	0.60
25-05-07	7.75	7.75	7.75	7.75	1.20	1.30	0.35	0.60

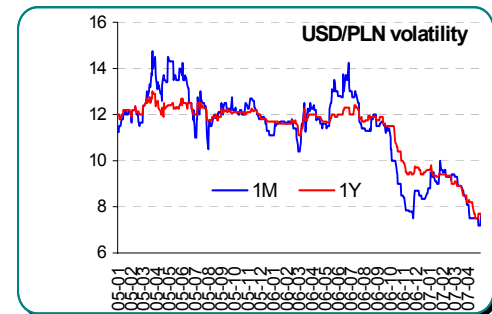
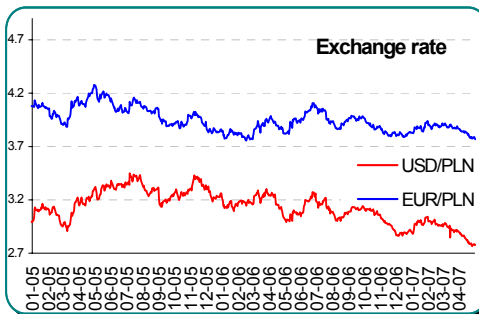
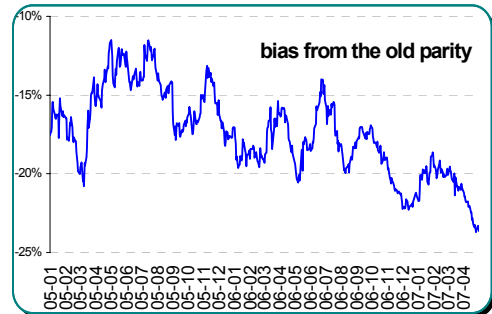
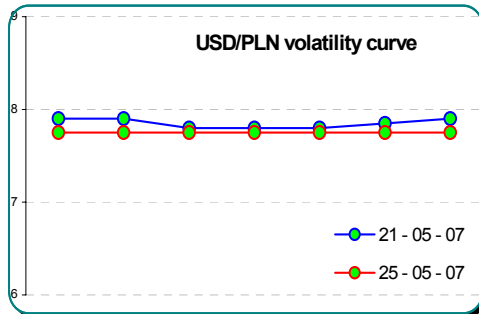
PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
21-05-07	2.8070	3.7742	-23.24%
22-05-07	2.8020	3.7966	-23.03%
23-05-07	2.8270	3.7964	-22.75%
24-05-07	2.8265	3.7966	-22.75%
25-05-07	2.8369	3.8113	-22.46%

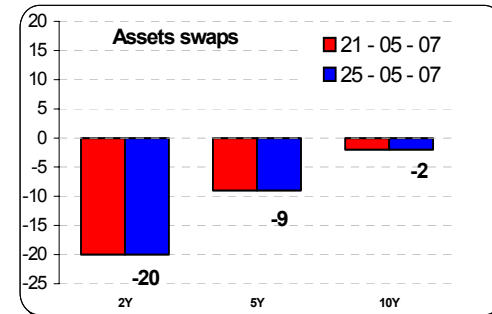
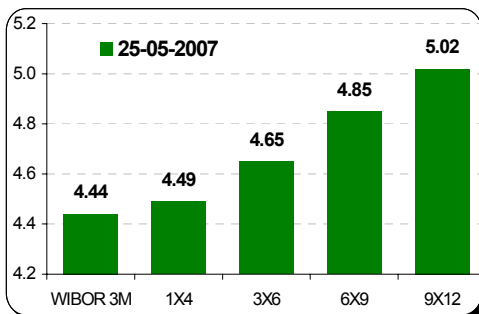
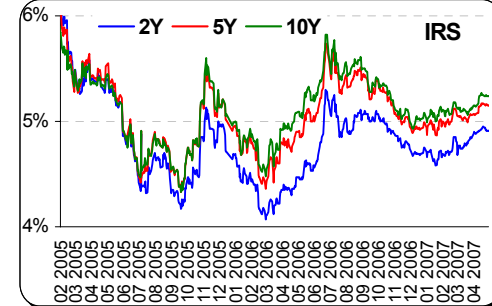
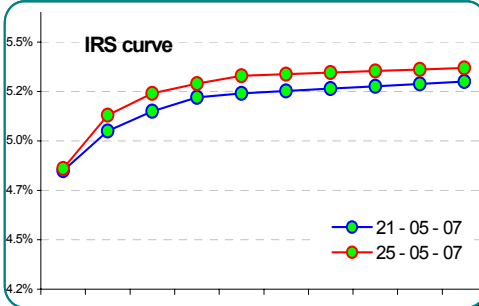
Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50
Mid-market volatility of vanilla option strategies

CHARTS

Foreign Exchange



Fixed Income



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CALENDAR

Macro

	February	March	April	Data Release	BRE Bank forecast
CPI m/m	0.3%	0.5%	0.5%	13-06-07	
CPI y/y	1.9%	2.5%	2.3%	13-06-07	
PPI m/m	0.3%	0.5%	0.6%	20-06-07	
PPI y/y	3.5%	3.3%	2.3%	20-06-07	
Industrial production growth m/m	-2.1%	14.7%	-8.7%	20-06-07	
Industrial production growth y/y	13.0%	11.3%	12.4%	20-06-07	
Average wages in enterprise sector [PLN]	2687.5	2852.7	2786.3	19-06-07	
Average wages in enterprise sector y/y	6.5%	9.1%	8.4%	19-06-07	
Unemployment	14.9%	14.4%	13.7%	22-06-07	
Budget realisation (%)	10.1%	16.1%	6.9%	15-06-07	
Current account [EUR mn]	-561	-539		15-06-07	
Balance of foreign trade in goods (transaction basis) [EUR mn]	-201	-627		15-06-07	
Exports growth y/y (transaction basis)	13.1%	15.8%		15-06-07	
Imports growth y/y (transaction basis)	12.3%	21.7%		15-06-07	
Current account [% of GDP]	-2.2%	-2.2%		15-06-07	
Money supply (M3)	490.6	492.8	498.7	14-06-07	
Money supply growth y/y	17.9%	18.1%	17.8%	14-06-07	
Total PLN loans [PLN bn]	383.6	392.6	402.8	14-06-07	
Households PLN loans	197.1	203.7	209.6	14-06-07	
Corporate PLN loans	148.2	151.4	155.2	14-06-07	
Total PLN deposits [PLN bn]	410.7	410.8	414.4	14-06-07	
Households PLN deposits	228.6	227.1	225.2	14-06-07	
Corporate PLN deposits	126.1	125.4	126.7	14-06-07	
NBP intervention rate	4.00%	4.00%	4.25%	30-05-07	4.25%

Auctions

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4.208%	16-01-06
26 Week T-bills	-	-	3.943%	24-04-06
52 Week T-bills	04-06-07	-	4.481%	07-05-07
2Y T-bond OK1208	06-06-07	-	4.694%	04-04-07
5Y T-bond PS0412	20-06-07	-	5.127%	16-05-07
10Y T-bond DS1017	11-07-07	-	5.244%	11-04-07
20Y T-bond WS0922	12-09-07	-	5.309%	14-03-07

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